Incentivising Tenants to Stay the Term – Will clawbacks be enforceable?

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Incentives are commonly offered by commercial landlords to tenants in the form of short term rent deductions or contributions to the tenant's fitout. Usually these incentives are conditional upon the lessee remaining in the premises for the term of the lease with an obligation on the tenant to repay a proportion of the fitout contribution and rent deductions upon early termination or assignment. While the enforceability of clawback provisions has always been unclear, there was commercial benefit to landlords in maintaining high rentals on the face of the lease and attracting good quality tenants through fitout contributions. The use of clawback provisions as part of these incentives was recently analysed by the Queensland Supreme Court through the lens of the penalties doctrine in *GWC Property Group Pty Ltd v Higginson & Ors* [2014] QSC 264, with a negative outcome for the landlord. Unless the decision is overturned on appeal, the salient message for landlords is that repayment of incentives for any reason, not just a breach of the lease, is unlikely to be enforceable.

Facts

The landlord and tenant entered into a lease and incentive deed on 11 November 2010 for a 7 year term with 3 options. The lease was guaranteed by a number of individuals who indemnified the landlord against loss suffered as a result of the tenant's breach of the lease. The incentive deed was stated to be 'intended to supplement the Lease' and include provision for the landlord to make a contribution to the tenant's fitout and grant abatements of the rent for 3 years and abatement of the signage fee. The incentive deed provided for repayment of the fitout contribution and the rent abatement in the event of early termination of the lease, other than for the Lessor's default. The deed required the tenant to repay a proportion of the fitout contribution relative to the number of days remaining until the end of the lease and all rent reductions received by the tenant to date. Relevantly the lessor also retained ownership of all fitout paid for by the lessor's contribution.

The lease was registered and the original landlord paid the fit out contribution and allowed the rent abatement. The reversion was transferred to the current landlord and the court assumed without deciding that that the new landlord took an assignment of all the rights and interests of the original landlord under the deed. Prior to the end of the third year of the lease the tenant abandoned the premises without cause.

By the time the dispute was heard by the court the tenant was insolvent and the guarantors had been released from the guarantee of the lease in exchange for a bank bond to cover their liabiliy. The court therefore considered the liability of the guarantors under the incentive deed. The primary issue was whether the obligation to repay the incentives after termination was a penalty and therefore unenforceable.

Decision

Dalton J considered first whether the penalties doctrine applied to the clawback provisions and secondly, if it did, whether the provisions constituted penalties in fact.

Application of the doctrine of penalties

In her Honour's view the clawback provisions were clearly subject to the doctrine of penalties on both the law prior to *Andrews v ANZ Banking Group Ltd* (2012) 247 CLR 205 (*Andrews*)and after. Both repayment of the fitout incentive and the rent abatement, although worded differently, were triggered by termination of the contract for breach. The lease may also have been terminated early for other reasons not amounting to breach. In her Honour's view this did not alter the conclusion. After an examination of the case law, her Honour concluded that the better view was that if one of the triggers for repayment was a breach of contract, the doctrine was applicable. In her Honour's view this conclusion was not altered by the decision in *Andrews* notwithstanding the statement of principle in that case did not readily accommodate the current contractual provisions. Application of *Andrews* to the clawback provisions required the repayment provisions to be viewed as collateral to the primary obligation under the lease to remain for the full term. Although the application to the facts was considered a little 'untidy', her Honour was of the view that the High Court did not intend the statement to be a rigid formula or to narrow the application of the doctrine.

The landlord argued that the payments should not be regarded as penal, but restitutionary in nature based upon the fact the condition upon which they were paid had failed. Although the clauses were drafted differently, Dalton J did not consider this relevant as both were payments that were not payable if the tenant had not breached the lease. The landlord argued that particularly in the case of the rent abatement, as a higher amount was due under the lease the requirement to repay was merely the withdrawal of the indulgence, which in reliance on previous authority did not make the clause subject to the penalties doctrine. See *Astley v Weldon* (1801) 126 ER 1318; *David Securities Pty Ltd v Commonwealth Bank of Australia* (1990) 23 FCR 1, 29. This argument was rejected as unlike the cases relied upon, the unabated rent would never be payable unless a wrongful termination occurred. Even though her Honour distinguished the previous line of authority, in the author's view, continued reliance upon clauses that withdraw indulgences or concessions as beyond the penalties doctrine is unwise after *Andrews.* The High Court clearly signalled in their judgment that lower courts to prefer substance over form when examining potential penalties.

The landlord further argued that the incentive deed should be considered separately to the lease as it did not contain any obligations to comply with the covenants in the lease. Its only purpose was to persuade the tenant to enter into the lease. Dalton J rejected this argument as commercially artificial. Clearly the bargain between the parties, as evidenced in the recitals to the incentive deed, was constituted by both the lease and the deed. This conclusion is also supported by the clear rule of construction that documents entered into at the same time and dealing with the same subject matter should be construed as one document. See *Manks v Whitely* [1912] 1 Ch 735.

Was the repayment penal or a genuine pre-estimate of loss?

Once it is established that a contractual provision is subject to the doctrine of penalties the next question for a court is whether the provision stipulates a payment that is unconscionable or extravagant in nature compared to the greatest loss that may occur. See *Ringrow Pty Ltd v BP*

Australia Pty Ltd (2005) 224 CLR 656 and *Paciocco v ANZ Banking Group Ltd* [2014] FCA 35. This assessment should take place as at the time of entry into the contract and not at the time the payment is required. In her Honour's view the payments were extravagant and far in excess of the amount the lessor would recover in a claim for damages for breach of the lease. Despite the clause apportioning the fitout repayment relative to the time remaining on the lease, in each case the lessor was entitled to repayment of the incentives in addition to common law damages for loss, which was specifically retained by the agreement.

Effect of clawback being a penalty

Following the decision in *Andrews*, the effect of a clause being a penalty is that the provision is unenforceable, except to the extent of the loss suffered by the failure of the primary stipulation. Generally compensation for the loss is assessed on the basis of damages at common law. The landlord argued that compensation should be awarded for the loss of the clawback. This argument was rejected on the basis the landlord should only be compensated for the prejudice suffered by the loss of the primary stipulation and not for the court's refusal to enforce the penalty.

In this case the appropriate compensation was damages for breach of the lease. Ordinarily this would include the rent to the end of the term, compensation for any failure to make good and the costs of finding another tenant with a reduction for any rent obtained from the new tenant. Damages are unlikely to include the cost of any future incentives granted by the landlord to attract a new tenant.

The difficulty for the landlord in this case was that the tenant was insolvent and the guarantors had been released from the guarantee of the lease in exchange for a bank bond being provided. Damages were not recoverable for breach of the incentive agreement as it did not contain any obligations on the part of the tenant. No damages were therefore awarded by the court.

Practical points for landlords

The clear message from the decision in *GWC Property Group Pty Ltd v Higginson* is that landlords will have great difficulty in recovering incentive payments from tenants upon termination of the lease in addition to damages for breach of contract. The ability of landlords to continue to recover incentives and draft around the decision is at best limited and at worse non-existent. Suggested distinguishing features of the decision (ie the landlord was not the original landlord and ownership of the fitout remained with the landlord) did not appear to impact the judgment and in the writer's view would not change the outcome.

The limited exceptions to application of the penalty doctrine outlined in *Andrews* and their potential application are:

(i) *The penalties doctrine is not 'engaged' if the "prejudice or damage to the interests of the second party by the failure of the stipulation is insusceptible of evaluation and assessment in money terms*". (*Andrews* at [11])
This is unlikely to apply in the context of a lease and termination for breach.

(ii) A provision will not be a penalty if there is an identifiable reciprocal benefit.
The principle is limited to where there is a direct reciprocal benefit as the price for the

payment, rather than a situation where the allocation of the payment was part of the broader risk allocation framework of the contract. Even though it may be possible to frame the right to repayment as consideration for allowing early termination, this will mean that damages for breach are not recoverable.

(iii) *The doctrine does not apply if the sum of money is payable because the promisor exercised an option in performance.*
Again while this may be appropriate if the incentive is particularly large the drafting of the provision in this way limits the right to claim damages.

This leaves a landlord with limited options. The first option is to continue to grant incentives to attract tenants knowing that if the tenant leaves early the incentives are not recoverable. There may be other commercial benefits, such as depreciation of fitout, and in most cases the tenant will stay for the full term. The second option is to find other ways to attract or incentivise tenants that do not require a payment by the landlord or recovery of the incentive from the tenant.